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# **Critical Reflections on the state of Anglo-American Bank Regulation in the post-GFC Era**

**Opening speech**

Gesellschaft für Rechtsvergleichung

34 Tagung für Rechtsvergleichung, 'Recht und  
Rechtsvergleichung in der Finanzcrise'),  
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# Presentation Objectives

- What is regulated post-GFC
- The diverging approaches of UK and US reforms
- The changed/enhanced role of public actors and of the state and the defeat of private law approaches

# What is Regulated

- Systemic Risk
- Big financial institutions called Systemically Important Financial Institutions (SIFIs) or (if active in cross-border/international arena) Globally systemically Important Financial institutions (G-SIFIs), essentially **too-big-to-fail** financial institutions
- Non-SIFI financial institutions
- OTC Derivatives
- Shadow Banking
- I do not deal with OTC derivatives and shadow banking in this presentation

# Systemic risk

- 1st definition: systemic risk is the risk that can potentially cause instability for large parts of the financial system, which individual firms could not protect themselves against
- 2<sup>nd</sup> definition: systemic risk is a phenomenon that reflects the sense of a 'broad-based breakdown' in financial system
- A strong systemic event that influences a number of institutions and consequently impairs the well-functioning of financial system is regarded as a systemic crisis.
- At the heart of systemic events lies contagion
- Thus, a strong systemic event may relate to aggregate fluctuations of credit (e.g., lending booms), contagion and joint crashes in securities markets

# Systemic Risk Regulation

- Changed approach to regulation
  - *macro prudential*
  - *Structural reform*
  - *New Bank resolution regimes*
  - *New Capital and Liquidity Regulations*
  - *Reform of OTC markets*
- Changed approach to supervision
  - *reform of regulatory structures*
  - *recovery and resolution plans (Living Wills)*

# The Financial Cycle

- There are cyclical patterns in leverage (the leverage cycle) and maturity mismatch positions in the financial system which betray a credit and liquidity cycle
- This means that, in good times, financial agents tend to underestimate risk and, subsequently, overinvest. This overinvestment is fuelled by credit. The credit cycle is in its upward swing. In bad times, the reverse happens: agents become more risk averse and reluctant to invest. In the extreme, this may accumulate in a credit crunch.
- Most financial crises were preceded by a credit boom
- Namely, **Financial imbalances** - in the form of credit and liquidity cycles – which might be building up in the boom period can subsequently do serious damage to the economy

# The Financial Instability Hypothesis

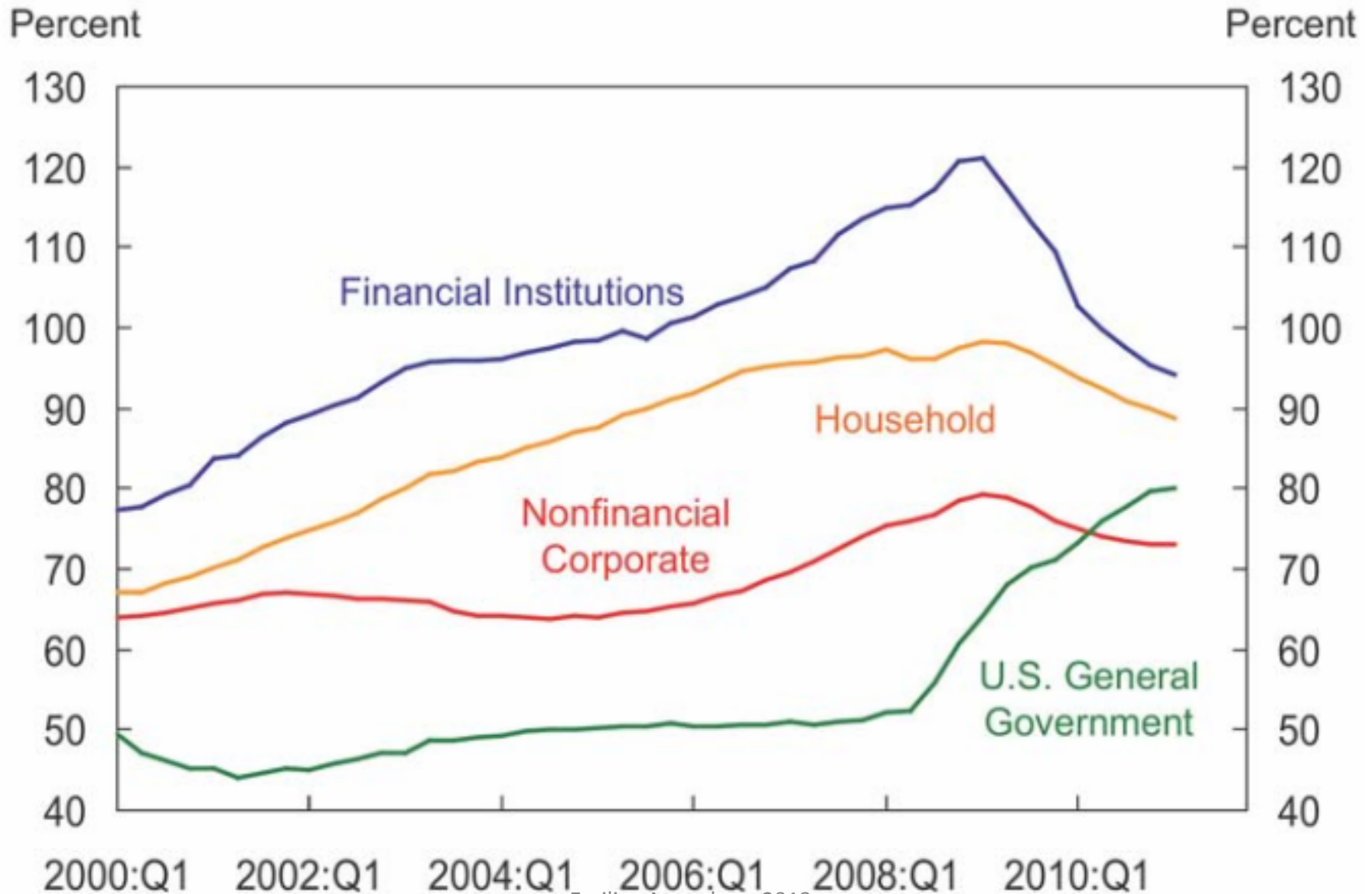
- The notion of financial imbalances is closely related to Minsky's financial instability hypothesis (Minsky, 1982).
- Minsky identifies three distinct income–debt relationships for economic actors/units, which he defined as hedge, speculative, and Ponzi finance stages.
- Market actors/units using hedge finance are those 'which can fulfill all of their contractual payment obligations by their cash flows'.
- Speculative finance units are economic units that can meet their payment commitments with respect to their liabilities, even though they would not be able to repay the principal out of income cash flows.
- In the case of Ponzi units, cash flows from operations are not sufficient to fulfill either the repayment of principal or the interest due on outstanding debts
- Thus, a Ponzi finance unit gradually becomes highly leveraged.



# Financial Instability Hypothesis

- What follows, as Minsky notes, is that the economy has financing regimes under which it is stable, and financing regimes under which it is unstable.
- Moreover, over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system.
- Accordingly, periods of protracted speculative euphoria (bubbles) lead to accumulation of debts that exceed what borrowers can repay from their income leading to a financial crisis.
- As lenders reduce the flows of credit to cope with the aftermath of over-lending, they indiscriminately ration credit, leading an economy into recession, a condition that in the last crisis was widely described as a 'credit crunch'.
- The gradual movement of the financial system from stability to crisis is commonly referred to as a 'Minsky moment'.

# Building up debt/leverage in the US financial sector



# Examples of time-variable macro-prudential instruments

- the Counter-cyclical buffer of Basel III –  
Premised on a credit to GDP growth ratio  
Aimed to make the system rather individual institutions more resilient and thus applied on a system-wide basis
- maximum to value (LtV) and loan to income (Ltl) ratios
- Time-varying leverage ratios
- In many ways credit-gap (i.e., credit to deposits) growth models and property prices are held to be the more reliable indicators of a financial cycle that is longer than the business or the economic cycle

## **But can it be effective? (i)**

- Can financials cycle be predicted and are the indicators used the right indicators? – some indicators predict the last cycle
- Macro-prudential policies are predominantly national and their impact will be limited if domestic credit flows can be substituted by cross-border flows, esp. with respect to transactions that rely more on the global capital markets, such as securitizations, and less on domestic lending (e.g., mortgages)
- In addition, in highly integrated markets the potential for spillover effects is massive when it comes to credit expansion, credit contraction and confidence in the financial system (e.g., the Spanish banking crisis)
- Therefore, there is a need for a level of coordination that is much higher than anything experienced so far

## Can it be Effective? (ii)

- The regime is more effective when it comes to influencing financial sector behaviour than business and household behaviour
- Thus, the present instruments will prove weak to smooth the financial cycle, if not per se, because
- They will create a border problem, business and households might look elsewhere for credit, but the policy will have limited impact on flows from the shadow banking sector
- Financial sector feedback loops as sources of endogenous risk have to be understood better and it is doubtful if they can be predicted with accuracy as they also involve the X factor of panic/agents' irrational risk aversion and wholesale runs
- Macro-models have to improve especially as regards credit supply friction, the behaviour of the leverage cycle and liquidity risks

# SIFIs & G-SIFIs

- **New regulations –**
- Structural Reform
- Capital adequacy standards: equally applicable to non-SIFIs
- New liquidity requirements – equally applicable to non-SIFIs
- G-SIFIs (super-charge): ‘a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. To provide a disincentive for banks facing the highest charge to increase materially their global systemic importance in the future, an additional 1% loss absorbency would be applied in such circumstances.’ (Basel Committee, 2011)
- Living Wills
- Convertible Capital Instruments (CoCos)
- New Resolution Regimes to ensure resolvability and prevent further bailouts

# The role of the G20 and of the FSB in Identifying and regulating G-SIFIs

- Designation of Global SIFIs is an international effort due to their contribution to cross-border contagion:
  - On November 4, 2011, the G20 Finance Ministers and Central Bank Governors, through the Financial Stability Board (FSB), published the names of an initial group of 29 banks determined to be “global systemically important financial institutions” (G-SIFIs)
  - At the same time, the FSB released an “integrated set” of policy measures to address the risks to the global financial system from G-SIFIs Among these policy measures was a publication of the Basel Committee on Banking Supervision which established an assessment methodology featuring an “indicator-based measurement approach” for evaluating systemic risk that weights both categories
  - Accepted indicators are Size, substitutability, interconnectedness, cross-jurisdictional activity, and complexity.

# UK & US Bank Regulation & Supervision

- **Supervision -**
  - **New Supervisory Structures:**
    - US: Financial Stability Oversight Council (FSOC) +
    - Federal Reserve Board (FRB) +
    - extensive powers to FDIC
    - UK: (Macroprudential) Financial Policy Committee (BoE) +
    - a microprudential regulator (the Prudential Regulation Authority – BoE) covers also non-SIFIs+
    - a conduct regulator the Financial Conduct Authority (FCA)
  - **Closer supervision by means of stress tests, etc.**
- **Strengthened corporate governance and increased responsibility for bank directors (can it be effective?)**
- **Structural Reform**
- **Recovery and Resolution Plans (Living wills)**



# Structure of SIFI Supervision- USA

- **Financial Stability Oversight Council**
- Title I of the Dodd-Frank Act, the Financial Stability Act of 2010, created the ***Financial Stability Oversight Council*** ) (FSOC).
- The FSOC was created to:
- Identify risks to US financial stability that could arise from:
  - the material financial distress or failure, or ongoing activities of large interconnected ***bank holding companies*** (BHCs) or non-bank financial companies; or
  - outside the financial services marketplace.
- Promote market discipline by eliminating expectations that the federal government will shield them from losses in the event of failure.
- Respond to emerging threats to the stability of the US financial system.

# Reporting to the FSOC

- The Act provides that the FSOC may request or require a variety of reports. In particular, the FSOC may, acting through the OFR:
- Request periodic or other reports from any non-bank financial company or BHC for the purpose of assessing the extent to which a financial activity or financial market in which the company participates, or the company itself, poses a threat to the financial stability of the US.
- Require an SSFI, and any subsidiary of the SSFI, to submit certified reports to keep the FSOC informed on the:
  - financial condition of the company;
  - systems for monitoring and controlling financial, operating, and other risks;
  - transactions with any subsidiary that is a ***depository institution***; and
  - extent to which the activities and operations of the company and any subsidiary of that company, could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall financial stability of the US.

# What Does the FSOC Do?

- Under the Act, the FSOC:
- Must monitor the marketplace to identify potential threats to US financial stability.
- Must monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and advise Congress and make recommendations in those areas that will enhance the integrity, efficiency, competitiveness and stability of the US financial markets.
- Must make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit or other problems spreading among BHCs, non-bank financial companies and US financial markets.
- Must identify regulatory gaps that could pose a risk to US financial stability.
- Must require the FRB to supervise non-bank financial companies that may pose a threat to US financial stability in the event of their financial distress or failure.
- Must make recommendations to the FRB concerning the setting of standards and reporting and disclosure requirements applicable to SSFIs. Recommendations may include:
  - risk-based capital requirements;
  - leverage limits;
  - liquidity requirements;
  - resolution plan and credit exposure report requirements; and
  - short-term debt limits.

# More than macro-prudential regulator?

- Examples of actions the FSOC has taken since its inception include:
- On January 18, 2011, issuing a study and recommendations on implementing the Volcker Rule and on concentration limits on large financial companies and
- On July 18, 2011, issuing final rules outlining the protocol for its designation of financial market utilities as systemically important
- On October 11, 2011, issuing a second notice of proposed rulemaking on the designation of systemically significant financial institutions under the Dodd-Frank Act
- On April 3, 2012, approving a final rule and interpretive guidance on the FSOC's authority to designate nonbank financial companies as SSFIs subject to enhanced regulation and oversight

# FSOC Membership

- The FSOC consists of 15 members: ten voting and five non-voting.
- The ten voting members are the Treasury Secretary, as Chairperson of the FSOC, an insurance expert appointed by the President and confirmed by the US Senate, and the heads of the:

***Federal Reserve Board*** (FRB).

***Office of Comptroller of the Currency*** (OCC).

***Federal Deposit Insurance Corporation*** (FDIC).

***Securities Exchange Commission*** (SEC).

***Commodities Futures Trading Commission*** (CFTC).

Federal Housing Finance Agency.

National Credit Union Administration.

***Consumer Financial Protection Bureau*** (CFPB).

- The five non-voting members of the FSOC are:

The director of the ***Office of Financial Research*** (OFR).

The director of the ***Federal Insurance Office*** (FIO).

A state insurance regulator by state insurance regulators.

A state banking supervisor chosen by state banking supervisors.

A state securities commissioner chosen based by state securities commissioners.

# FSOC Voting

- Except where specified in the Act, decisions of the FSOC are to be made by majority vote, with each member of the FSOC having one vote. However, in certain cases, the Treasury Secretary as Chairperson has greater rights. For example:
- Although a two-thirds supermajority vote is required to designate a non-bank financial company as a ***systemically significant financial institution*** (SSFI) and requiring enhanced prudential supervision, the Treasury Secretary must vote in favour of that designation.
- The Treasury Secretary can exclude non-voting members from the FSOC's deliberations

# The Role of the FRB

- The authority of the FRB has been considerably expanded under the Act. In addition to its role on the FSOC, the FRB now has regulatory authority over entities historically outside its purview such as holding companies.
- **Entities Under the Supervision of the FRB**
- Regulatory authority granted to the FRB under the Federal Reserve Act to supervise, among others: BHCs and state chartered banks that have elected to join the ***Federal Reserve System***
- In addition, the FRB now has:
- Regulatory authority over SSFIs
- As a result of the elimination of the ***Office of Thrift Supervision*** (OTS), supervisory and rule-making authority over thrift holding companies and their non-depository institution subsidiaries.
- In addition, the Dodd-Frank requires that the US Government Accountability Office (GAO) publish a report on the effect of removing certain exemptions from the definition of the term "bank" under the Bank Holding Company Act of 1956 (BHC Act). These include exemptions for credit card banks, industrial loan companies and thrifts. Removal of these exemptions would subject the parent holding companies to regulation by the FRB as bank holding companies. On January 19, 2012, the GAO issued that report, but made no strong recommendations on whether to remove the exemptions

# FRB's Regulatory Authority

Under the Act, the FRB's regulatory obligations include:

- Considering the recommendations made by the FSOC for heightened or enhanced prudential standards for SSFIs and any other companies that the FSOC has identified as requiring greater supervision because of, among other things, their size and riskiness.
- Consulting with the relevant FSOC member before imposing prudential standards that may have a "significant impact" on a subsidiary of a SSFI that is regulated by that FSOC member. Reviewing and approving SSFIs' resolution plans ("living wills").
- Conducting stress tests of SSFIs.



# Emergency Lending Authority

- The Act modifies Section 13(3) of the Federal Reserve Act to provide that the FRB may only authorize a ***Federal Reserve Bank*** to provide financial assistance to failing institutions as part of a program or facility "with broad-based eligibility." A program does not have broad-based eligibility if it is structured to remove assets from a single and specific company's ***balance sheet***, or if it is created to assist a single and specific company in avoiding bankruptcy, resolution by the FDIC or any other insolvency proceeding.
- The FRB must, in consultation with the Treasury Secretary, adopt policies and procedures governing emergency lending designed to ensure that any lending provided by the FRB and the Federal Reserve Banks provides liquidity to the financial system and not to aid a single and specific failing financial institution.
- This provision is aimed at avoiding the financial assistance that was given to Citigroup, Bank of America, AIG and other financial institutions during the financial crisis.

# The Expanded Supervisory Role of the FDIC

- The authority of the FDIC has been considerably expanded under the Dodd-Frank Act:
- It is a voting member of the FSOC.
- Must approve living wills of SSFIs required to be submitted under the Act.
- May be appointed as receiver of any financial company if certain conditions are met.
- Must consult with the FRB to set requirements for early remediation of a financial company in financial distress. These requirements include, for companies:
  - in the initial stages of financial decline, limits on capital distributions, acquisitions and asset growth; and
  - in the later stages of financial decline, a capital restoration plan, capital raising requirements, limits on transactions with affiliates, management changes and asset sales.

In addition to its role on the FSOC, the Act gives the FDIC supervisory (but not rule-making) authority over state chartered thrifts

Finally, the FDIC has the right to liquidate or resolve failing financial companies

# US Regulation of SIFIs

- An institution that could be designated systemically significant pursuant to Section 113 Dodd Frank Act includes any US or Foreign company that is, 'predominantly engaged in financial activities,' other than a foreign banking organization that is treated as a bank holding company in the USA, a bank holding company, and certain other types of entities subject to bank or bank-like regulation.
- FSOC final rule, which was approved in April 2012. This gives the FSOC the power to designate certain financial institutions as systemically important. This is achieved quantitatively by size, but the FSOC still retains substantial discretion. US firms are considered on a global basis, whereas, foreign firms will only be judged by their US assets and liabilities. If the FSOC deems that a firm is not able to meet its requirements then it can decide to label a company as a non-bank Systemically Important Financial Institution (SIFI).

# US Regulation & Supervision of SIFIs – Living wills

- On October 17, 2011, the Federal Reserve approved a final joint rule implementing the requirement of the Dodd-Frank Act that SIFIs periodically report “the plan of such company for rapid and orderly resolution in the event of material financial distress or failure” to the Federal Reserve, the FDIC and the Council.
- Pursuant to the rule, designation of a financial institution as a SIFI has significant consequences with respect to a financial institution’s planning and preparation for potential financial distress or insolvency.
- The institution will be required to prepare a so-called “living will,” or contingency plan, for resolving its affairs under the U.S. Bankruptcy Code in the event that it experiences material financial distress.
- If the institution is in danger of becoming insolvent, the FDIC may be appointed receiver pursuant to the Orderly Liquidation Authority contained in Article II of the Dodd-Frank Act.<sup>66</sup> In such case, the Secretary of the Treasury will use the institution’s “living will” to determine whether resolution of the institution’s affairs is best achieved under the Bankruptcy Code or the Orderly Liquidation Authority.

# STRUCTURAL REFORMS UK-US

- VOLCKER RULE prohibits banks from:
- “1) engaging in proprietary trading”
- “2) acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund.”
- The regulatory implementation of the Volcker Rule, however, has been significantly weakened by numerous exceptions and variances • SIZE LIMITATIONS: Cap on assets/liabilities (Dodd-Frank cap very lax)
- STRUCTURAL REFORMS – UK’s ring-fencing

# Ban on Proprietary Trading

- “Proprietary trading” is defined as “engaging as a principal for the trading account of the banking entity or [relevant] nonbank financial company . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal agencies . . . determine [by rule].” 12 U.S.C. §1851(h)(4).
- “Trading account” primarily refers short-term trades, though federal regulators could expand that coverage. 12 U.S.C. §1851(h)(6).
- Exceptions: trading is permitted “in connection with underwriting or market-making, to the extent that either does not exceed near term demands of clients, customers, or counterparties; on behalf of customers; or by an insurance business for the general account of the insurance company.” (12 U.S.C. §1851(a)(1), the Dodd-Frank Wall Street Reform and Consumer Protection Act).

# Ban to trade in or sponsor shadow banking entities

- Section (§ 619), the "Volcker Rule," prohibits any banking entity, including affiliates of banks, from:
  - (i) sponsoring, or investing in, a hedge fund, private equity fund, and potentially numerous other types of privately offered funds and pooled investment vehicles, including venture capital funds, real estate funds, structured finance vehicles and some types of special purpose vehicles used in project finance transactions,
- **except for funds that are organized or offered by the banking entity**, subject to:
  - (a) the banking entity owning no more than 3% of the fund;
  - (b) an overall limit of 3% of the banking entity's Tier 1 capital invested in private funds; and
  - (c) other limitations, including as to the name of the fund, and affiliated transactions.
- In addition, the banking entity may make seed investments in a fund, including owning 100% of a fund, for up to one year.
- **Other Restrictions.** Any banking entity that sponsors a private fund, any banking entity that acts solely as an investment adviser to a private fund (even if it does not otherwise sponsor the fund), and any affiliate may not enter into a transaction with such fund that would be a "covered transaction" as defined under Federal Reserve Act Section 23A, and is also subject to Section 23B, except that the Federal Reserve may allow prime brokerage transactions if certain requirements are met.

# UK's Ring-fencing Approach

## Vickers Report and the Financial Services Act 2013

- In June 2010, the UK established an Independent Commission on Banking to consider structural and non-structural reforms to the UK banking sector to promote financial stability and competition.
- Chaired by Sir John Vickers, the Commission published its final report (widely known as the Vickers Report) in September 2011.
- The goals of the Commission were threefold: to “reduce the probability and impact of systemic financial crises”; to “maintain the efficient flow of credit to the real economy”; and to “preserve the function of the payments system and guaranteed capital certainty and liquidity for small savers.”
- To meet these goals, the Vickers Report recommended a combination of structural reform and “enhanced loss-absorbing capacity.”
- Ring-Fencing: Banks would be required to take deposits from, and provide overdrafts to, those individuals and enterprises **through separate subsidiaries that could not engage in activities that might expose them to loss, such as trading book activities, purchasing loans or securities, and derivatives trading.**



# The ‘Height of the Fence’

- The Vickers Report also made recommendations about what it called the “height” of fence:
- It recommended recommendation that each ring-fenced subsidiary should be a separate legal entity that adheres to strict arm’s length formalities appears to provide a measure of bankruptcy remoteness.
- This means that each ring-fenced subsidiary should meet certain regulatory requirements for capital, liquidity, and funding appears to enable such subsidiary to operate, if needed, on a standalone basis.
- Each ring-fenced subsidiary should only engage in arm’s length transactions with affiliates and should have a majority of its directors, including the chair, be independent to preserve the subsidiary’s business and assets from cross-group exposures.

# The Post-2009 UK Bank Resolution Regime

- Post- Northern Rock rescue it became commonplace belief that banks are special entities to which the application of general insolvency law in the event of failure does more harm than good and they should be subjected to special resolution laws. To this effect the UK adopted a Special Resolution Regime (SRR) following the enactment of the 2009 Banking Act (now amended), which gives the UK authorities a permanent framework providing tools for dealing with failing UK banks and building societies. It gave the Bank of England a key role in implementing a resolution using the statutory resolution tools. The SRR powers are carried out by the Special Resolution Unit which leads in the work required to select and implement a resolution tool.
- In descending order, the Banking 2009 Act gives the government three "stabilisation options" with respect to seriously troubled banks. The first option is to find a private sector purchaser for the bank's shares or property. It includes the power to effect share or property transfers by order. The second option is to transfer the bank's business (but not its shares) to a government owned bridge bank, which will hopefully off-load that business to the private sector within a year. The third stabilisation option is to place the bank's shares into "temporary public ownership" (the Act's euphemism for nationalisation), although the Act sets no deadline for ending that arrangement. In practical terms, all three options were available under the 2008 Act, although the 2009 Act contains new language ("temporary") and new mechanisms ("bridge bank"). Action under the first two options can be limited to specific parts of the bank. That would enable the UK government to implement a TARP

# The UK's SRR

- In 2009 the UK Treasury had an "Asset Protection Scheme" which was not tied to the banking sector but still borne similarities to TARP.
- The far-reaching powers given under the Act are to be exercised in the public interest, whose principal criterion was the avoidance of a serious threat to the stability of the UK financial system.
- The 2009 Act's three stabilisation options can be exercised unless the relevant bank has either breached or is likely to breach minimum regulatory requirements as to capital adequacy or prudential management.
- The further requirements in the case of either of the first two options are that government intervention is needed to protect the public interest in "the stability of the financial systems of the United Kingdom, ... the maintenance of public confidence in the stability of the banking systems of the United Kingdom, or ... the protection of depositors".
- The 2009 Act's objectives also talk of stability and public confidence, as well as the protection of depositors' and public funds and, curiously, the avoidance of a contravention of the HRA's protection of property rights. None of those objectives is ranked. Treasury has issued a Code of Practice to give further guidance.

# THE US BANK RESOLUTION REGIME SOME HISTORY

- Most of the historical literature concerning the New Deal banking reforms concentrates on the so-called Glass-Steagall Act, which was in fact only part of the Banking Act 1933. Various praised and condemned, that part quarantined investment banking from commercial banking, on the theory that traditional banking should not chase the high-risk profits of investment banking. The same Act introduced the FDIC, whose success is not as contested.
- Perhaps more interesting than Roosevelt's laws were his assumptions of power to declare new (and temporary) law as the Commander in Chief.
- He summoned an emergency session of Congress within the first fortnight of his presidency, to pass the Emergency Banking Act 1933 (US). The speed with which the Bill became law was astonishing. No printed copies were available, and members had to listen to the Clerk's reading of it and then pass it immediately. They also had to approve a resolution "ratifying" Roosevelt's emergency declarations. All of these measures were announced in the language of "war", and some of them were presented as if they were a simple extension of a 1917 Act concerned with enemy property (although the full name of the old Act was air-brushed out). Roosevelt's declarations and his new emergency Act were obviously arbitrary, and in some respects, appalling. His appropriation of the language of war set a precedent for claims by subsequent Presidents for unquestioning obedience to emergency measures.
- But by the time that serious challenges were to reach the Supreme Court, government by the President had softened into government by regulatory agencies, which latter style the court eventually upheld.

# THE US RESOLUTION REGIME FOR SIFIs

- **Orderly Liquidation Authority**
- Title II of the Dodd-Frank Act sets out a new process for handling the insolvency and **liquidation** of qualifying financial companies and their subsidiaries. Under the Act, the Treasury Secretary has the authority to appoint the **Federal Deposit Insurance Corporation** (FDIC) as receiver of these companies if certain conditions are met. The FDIC's resolution and receivership authority is modelled on the **Federal Deposit Insurance Act** (FDI Act) with some elements from the **Bankruptcy Code**. There are meaningful differences, however, between these laws and the orderly liquidation authority set out in Title II of the Act. Although the FDIC has some of the same authority and powers to resolve qualifying financial institutions as it does under the FDI Act to resolve **depository institutions**), some of its broad powers under the FDI Act have been modified for the purposes of resolving financial companies. In addition, whereas the Bankruptcy Code is generally designed to protect the interests of creditors Title II is drafted to minimize the effects of the company's failure on the US financial system and the resources of the US Treasury. It is also intended to address concerns of moral hazard.
- The purpose of the FDIC's resolution authority over financial companies is to:
- Eliminate taxpayer bailouts of companies that have historically been considered "too big to fail."
- Ensure that the failed companies' stockholders, creditors and other counterparties bear the risk of these companies' failure.
- Provide an orderly and rational mechanism for liquidating and resolving **systemically significant financial institutions** (SSFIs) and other financial companies whose liquidation may have an adverse impact on US financial stability and that cannot appropriately be handled under another applicable law (for example, the Bankruptcy Code).

# Scope of OLA

- **Companies Subject to the FDIC's Resolution Authority**
- Until the Act's passage, the insolvency of financial institutions was conducted in the case of:
  - Insured ***depository institutions*** by the FDIC under the FDI Act. These institutions will still be resolved under the FDI Act.
  - Insurance companies, by the relevant state authorities under that state's laws.
  - ***Broker-dealers*** (by the Securities Investor Protection Corporation (SIPC) under the Securities Investor Protection Act of 1970 (SIPA).
  - Other financial companies, by a bankruptcy court under the Bankruptcy Code.
- Under the Act, the FDIC's authority may be invoked for the resolution of any financial company if certain conditions are met. For purposes of Title II, financial company is defined as any company incorporated or organized under Federal law or any US state that is a:
  - ***Bank holding company*** (BHC).
  - Non-bank SSFI.
  - Company predominantly engaged in activities that are financial in nature or incidental thereto for purposes of Section 4(k) of the Bank Holding Company Act (BHCA).
  - Subsidiary of any of the companies described above that is predominantly engaged in activities that are financial in nature or incidental thereto for purposes of Section 4(k) of the BHCA other than an insured depository institution or insurance company.

# Treasury Secretary Determination

- Once it has received the recommendation of the FRB and the FDIC (or the SEC or the director of the FIO, as applicable), the Treasury Secretary, in consultation with the President, may determine that the appointment of the FDIC as receiver of the financial company is warranted if it finds that the following conditions are met:
- The financial company is in default or in danger of default.
- The failure of the financial company and its resolution under another law (for example, the Bankruptcy Code or the applicable state law) would have serious adverse effects on financial stability in the US.
- No viable private sector alternative is available to prevent the default of the financial company.
- Any effect on the claims or interests of the financial company's creditors, counterparties and stockholders and other market participants as a result of actions to be taken by the FDIC is appropriate, given the impact that any action under Title II would have on US financial stability.
- Liquidation by the FDIC would avoid or mitigate the serious adverse effects on financial stability in the US, taking into account the effectiveness of the action in mitigating the:
  - potential adverse effects on the financial system;
  - cost to the US Treasury; and
  - the potential to increase excessive risk taking on the part of the financial company's creditors, counterparties and stockholders.
- A federal agency has ordered the financial company to convert all of its convertible debt instruments to equity.
- The company meets the definition of a financial company.
- A financial company that the Treasury Secretary has determined the appointment of the FDIC as its receiver is warranted is known as a covered financial company.
- No later than 24 hours after making this determination, the Treasury Secretary must notify Congressional leaders of this determination and the basis for its determination.

# Safeguards

- **Judicial Review of Covered Financial Company Designation**
- If the Treasury Secretary determines that a financial company is a covered financial company and the FDIC should be appointed as receiver, the financial company has the option to consent to the appointment. If it does not consent to the appointment, the Treasury Secretary must petition the US District Court of the District of Columbia (DC District Court) for an order authorizing the appointment.
- In reaching a decision as to whether this order should be granted, the DC District Court must determine that the Treasury Secretary's determination was not "arbitrary and capricious" in its determination that the company is:
  - A financial company under the relevant title of the Dodd-Frank Act.
  - In default or in danger of default.
- The DC District Court must rule on the Treasury Secretary's petition within 24 hours. If it does not, the order is automatically granted. The affected company may appeal the decision to the US Court of Appeals for the District of Columbia and then the US Supreme Court on an expedited basis but any appeal does not stay the receivership proceedings.
- **Related Rulemaking Developments**
- On March 15, 2011, the FDIC issued a proposed rule that would clarify whether a company is deemed to be predominantly engaged in financial activities for purposes of the FDIC's resolution authority



# FDIC's Role

- FDIC Appointment
- Once appointed, the FDIC's receivership stays in place for three years but may be extended for two additional one year terms to complete any ongoing litigation or other proceeding.
- In its capacity as receiver, the FDIC must liquidate the covered financial company and in a manner that minimizes risks to US financial stability and moral hazard so that:
  - Its creditors and stockholders bear the company's losses.
  - Management responsible for the company's condition is not retained.
  - The FDIC and other federal agencies take all steps necessary and appropriate to ensure that all parties having responsibility for the company's condition (for example, directors and officers) bear losses consistent with their responsibility, including actions for damages, restitution and recoupment of compensation.

# Effect of FDIC appointment

- **Effect of Appointment**
- The authority of the FDIC concerning a covered financial company is similar to the authority it has over insured depository institutions under the FDI Act. Once the FDIC is appointed as **receiver**, the:
- FDIC succeeds to all of the rights, privileges, titles and powers of the covered financial company, its stockholders, directors and officers and has the right to take all actions necessary to liquidate the covered financial company:
  - organizing a bridge financial company to which assets of the covered financial company may be transferred; and
  - merging the covered financial company or transferring its assets or liabilities to another company without the consent of the company's directors or stockholders or any other federal agency.
- Bankruptcy Code no longer applies.
- **Covered financial company must be liquidated.**
- The FDIC's rights under the Act are different from insolvency or bankruptcy proceedings under the Bankruptcy Code where the:
- Insolvent company's board and officers usually remain in control of the company and have decision-making authority over the company and its operations, subject to the restrictions of the Bankruptcy Code and bankruptcy judge.
- Company usually retains possession of its assets.

# Scope of FDIC's Authority

- In taking any action to resolve the covered financial company, the FDIC must:
- Determine that taking action is necessary for purposes of the financial stability of the US and not for the purpose of preserving the covered financial company.
- Ensure the stockholders of the covered financial company do not receive payment until after all other claims and the Orderly Liquidation Fund are fully paid
- Ensure that ***unsecured creditors*** bear losses in accordance with the priority of claim provisions.
- Ensure removal of management responsible for the failure of the covered financial company condition.
- Ensure that the members of the board of directors responsible for the failed condition of the covered financial company are removed, if those members have not already been removed at the time the FDIC is appointed as receiver.
- Not take an equity interest in, or become a stockholder of, any covered financial company or any covered subsidiary.
- The Act also includes a new mechanism for the FDIC to address derivatives contracts to which the covered financial company is a party. For more information on these contracts

# Scope of FDIC's Authority

- **Subsidiaries of a Financial Company**
- If the FDIC is appointed as receiver of a financial company, it may also appoint itself as receiver of a US subsidiary of that company if the FDIC together with the Treasury Secretary determine that this appointment is required because the:
  - Subsidiary is in default or in danger of default.
  - Appointment would avoid or mitigate the effects of the subsidiary's failure and liquidation on the US financial system.
  - Appointment would facilitate the orderly liquidation of the company.

# Implementation

- On October 12, 2010, as an initial step in implementing the FDIC's resolution authority, the FDIC issued a proposed rule outlining its treatment of creditor claims when appointed receiver of a covered financial company
- On January 18, 2011, the FDIC announced an interim final rule clarifying its treatment of certain creditor claims under its orderly liquidation; it also issued a general counsel's
- On March 15, 2011, the FDIC issued a proposed rule that would clarify the claims process and establish a framework for the priority payment of creditors and compensation recoupment from senior executives and directors of a failed SSFI
- On July 6, 2011, the FDIC issued a final rule implementing certain orderly liquidation authority provisions of the Dodd-Frank Act. It follows and largely coincides with the January 18, 2011 interim final rule and the March 15, 2011 proposed rule but also contains several key differences
- In a May 10, 2012 speech to the Federal Reserve Bank of Chicago Bank Structure Conference, acting FDIC chairman Martin J. Gruenberg detailed the FDIC's orderly resolution strategy for SSFIs. The outlined orderly resolution strategy involves:
  - Placing the SSFI's parent company into receivership while leaving the subsidiaries to continue operating as going-concern counterparties.
  - Transferring most of the SSFI's assets and some liabilities into a bridge company that would undergo a debt-for-equity swap similar to a restructuring under Chapter 11 of the Bankruptcy Code.
  - Eventually transferring ownership and control of the bridge holding company to private hands.

# Who covers the cost of Resolution? (i)

- **Orderly Liquidation Fund**
- To finance the FDIC's resolution of a covered financial company, the Dodd-Frank Act creates a segregated fund at the Treasury Department (the Orderly Liquidation Fund). This fund is not pre-funded but the FDIC is authorized to borrow (by issuing bonds) from the US Treasury the amount it needs to liquidate that covered financial company up a maximum equal to, in the aggregate:
  - 10% of the covered financial company's total consolidated assets during the first 30 days after the FDIC's appointment as receiver.
  - 90% of the fair value of the covered financial company's total consolidated assets after the first 30 days.
- **Repaying the US Treasury**
- The Act provides that no taxpayer funds can be used to resolve a covered financial company. Before the FDIC can borrow any money from the US Treasury to finance the liquidation of a covered financial company, it must enter into an agreement with the Treasury Department which:
  - Sets out a specific plan and schedule (which must be within 60 days) for repaying the amount borrowed.
  - Demonstrates that the income earned from the liquidation of the covered financial company (plus any assessments) will be sufficient to repay the loans in accordance with the agreed schedule.

# Who covers the cost of Resolution? (ii)

- **Risk-based Assessments**
- If the income that will be earned from liquidating the covered financial company's assets are insufficient to repay to the US Treasury the amounts borrowed to finance the liquidation, the FDIC must impose assessments on claimants that received additional payments under the liquidation process. If that is still insufficient, the FDIC may impose assessments on eligible financial companies (defined as systemically significant financial institutions and financial companies with total consolidated assets greater than \$50 billion). These assessments are based on the risk and assets of the companies including among, other things, the:
  - Risk these eligible financial companies pose to the US financial system.
  - Extent to which they have benefited or are likely to benefit from the orderly liquidation of the covered financial company.
  - Amount, categories and concentration of a financial company and its affiliates' on and off-balance sheet assets and liabilities.
  - Activities and market share of these eligible companies.

# Differences between the UK and the US Bank Regulation & Resolution Regimes

- The UK does not have an explicit distinction between SIFI and non-SIFI supervision & resolution
- In the US bank regulation has been formally & explicitly been politicized given the extensive powers of Treasury Secretary in connection to SIFI designation and OLA
- Although Title II was enacted to ensure the orderly liquidation of companies that may have an adverse effect on the US financial system, it is intended to be an option of last resort.
- As a result, Title II contains many procedural hurdles, including the requirement that several federal regulators determine that the company poses a **systemic** risk to US financial stability before the FDIC can be appointed as the receiver of that company
- The UK does not have a mandatory liquidation requirement for SIFIs in resolution (nor does the EU framework)
- BoE governor has become an uber-regulator and uber-economic policy-maker
- Will it work?



# ***Cross- border Resolution strategies***

- The Financial Services Act 2010 requires banks to submit recovery and resolution plans to the FSA (the PRA in future), which has to consult the Bank's resolution team and HMT on this. The Key Attributes require resolution plans to be drawn up for G-SIFIs by home and key host authorities working together. Recently the FSB has issued a consultative document that, amongst other things, sets out two broad types of resolution strategy (with a spectrum in-between)
- Single point of entry (SPE) resolution involves the application of resolution tools by the home authority at the top of a G-SIFI group to resolve problems in the group as a whole.
- Multiple point of entry (MPE) resolution involves the application of resolution tools by a number of home and host resolution authorities to multiple companies in the group, with the overall plan co-ordinated by the home authority.
- Which type of resolution strategy is better for a particular group will depend on the structure of the group, the nature of its business, and the size and location of the group's losses. For an "SPE" resolution to be appropriate, loss-absorbing instruments must have been issued at the top of the group and be available to cover losses in the group's subsidiaries. This is achieved by imposing losses, for example through a bail-in, on the external creditors of the parent holding company and writing down the value of loans from the parent to its operating subsidiaries in a manner that ensures those subsidiaries remain solvent and viable. For "MPE" to be appropriate, it needs to be feasible to separate the group financially, operationally and legally along national or regional lines, and then for each distressed entity to be resolved on a stand-alone basis. The parts might be resolved using bail-in of external debt or other resolution techniques.
- In either case, for bail-in to be the chosen resolution tool there needs to be sufficient loss-absorbing capacity in the relevant legal entities.

# US-UK SPE MoU

- In December 2012 the BoE and FED signed a MoU extending an SPE resolution strategy to US and UK Bank holding companies
- **It provides resolution strategies for the failure of globally active, systemically important, financial institutions (SIFIs or G-SIFIs)** with significant operations on both sides of the Atlantic.
- The goal is to produce resolution strategies that could be implemented for the failure of one or more of the largest financial institutions with extensive activities in our respective jurisdictions. These resolution strategies should maintain systemically important operations and contain threats to financial stability. **They should also assign losses to shareholders and unsecured creditors in the group, thereby avoiding the need for a bailout by taxpayers.**
- **The joint US/UK resolution states that depositor haircuts are already legal in the UK thanks to the 2009 UK Banking Act:**
- In the U.K., the strategy has been developed on the basis of the powers provided by the U.K. Banking Act 2009 and in anticipation of the further powers that will be provided by the European Union Recovery and Resolution Directive and the domestic reforms that implement the recommendations of the U.K. Independent Commission on Banking. **Such a strategy would involve the bail-in (write-down or conversion) of creditors at the top of the group in order to restore the whole group to solvency.**

# Looking into the future of the SPE (i)

- Application of SPE strategy can only be achieved within a legislative framework that provides authorities with key resolution powers.
- The FSB Key Attributes have established a crucial framework for the implementation of an effective set of resolution powers and practices into national regimes. In the U.S., these powers had already become available under the Dodd-Frank Act. In the U.K., the additional powers needed to enhance the existing resolution framework established under the Banking Act 2009(the Banking Act) are expected to be fully provided by the European Commission's proposals for a European Union Recovery and Resolution Directive (RRD) and through the domestic reforms that implement the recommendations of the U.K. Independent Commission on Banking (ICB), enhancing the existing resolution framework established under the Banking Act.
- Thus the development of SPE resolution strategies is being carried out in anticipation of such legislation.

# Looking into the future of the SPE (ii)

- **Unsecured debt holders can expect that their claims would be written down to reflect any losses that shareholders cannot cover**, with some converted partly into equity in order to provide sufficient capital to return the sound businesses of the G-SIFI to private sector operation.
- Sound subsidiaries (domestic and foreign) would be kept open and operating, thereby limiting contagion effects and cross-border complications. In both countries, whether during execution of the resolution or thereafter, restructuring measures may be taken, especially in the parts of the business causing the distress, including shrinking those businesses, breaking them into smaller entities, and/or liquidating or closing certain operations.

# Public/private law conflict in resolution

- The threat of corporate insolvency is usually regarded as a necessary ingredient of free markets, which means that government interventions are exceptional. Whilst most countries have schemes that look after depositors in the event of a bank insolvency, and most central banks use their powers as lender of last resort to give short-term assistance to fundamentally sound banks, the present economic crisis has occasioned more drastic government interventions. These include the installation of government managers into a troubled bank and government-subsidised takeovers by otherwise unwilling private sector purchasers. Such interventions raise serious issues

# The character of Resolution Laws

- UK & US Banking legislation is transferring to government authorities huge powers to decide the future of any bank that looks like wobbling; this includes power to make subordinate legislation that overrides private property and contractual rights, that overrides other statutes, and that can even be retrospective. In effect, this legislative activity decides nothing, but delegates all decisional powers to government. Emergency legislation has always been like that.
- This all reminds us of laws passed during the Great depression (See **Mark Aronson**, 'The Great Depression, this Depression, and Administrative Law' 166 *Federal Law Review*, Volume 37

# Unresolved Issues

- **Definition of bank & regulatory perimeter**
- It has never been an easy task to define what is a bank under the law. A previous edition of this book offered a definition based on the wording of legal texts and placed emphasis on the fact that a bank accepts deposits. However, a number of other functions were not caught as there were considered to be the realm of institutions that are were not classified as banks. Yet the complex nature of today's banking leaves little room for similarly neat approaches.
- [Therefore, it may be expected that future legal definitions of what is a bank will retain maturity transformation deposit taking and lending at the core of bank activity will also make reference to other characteristics such as eligibility for central bank liquidity support, and provision of essential infrastructure services to retail and wholesale customers, especially payments.

# Conclusions (i)

- Financial stability does not exist in the absence of the right institutions
- • In building those institutions general law might have to be amended/reformed or just ignored
- E.g., banks require special insolvency laws which not only bypass general insolvency law but also ignore shareholder rights grounded in general company law



# Conclusions (ii)

- **Private Ordering of Public markets ( a time old problem – e.g., CRAs, self-regulation) is rapidly receding**
- the public-private partnership in production of regulation and its enforcement (regulatory enrolment) as well its derivative risk-based regulation are equally on the wane
- Public law and regulators are greatly encroaching in areas that were largely the realm of private law
- **Excessive regulatory power**
- At the same time, the burden on regulators is beyond excessive and it's interesting to see **if they manage to successfully discharge a vast array of newly conferred duties**
- **Regulatory accountability remains a 'black box'**